Too Many Fund Investors Settle for Less: Morningstar Study

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A consistent warning raised by behavioral finance researchers is that investors too often prove to be their own worst enemies. Succumbing to short-term strategies related to performance chasing, they wind up failing to fully capture all of the benefits that markets can provide over time.

As we've covered in the past, studies by Dalbar Inc. have consistently shown that most fund investors suffer lower returns by trying to time markets. Morningstar has also looked into the ill effects of taking a tactical — as opposed to strategic — view of portfolio management. In their latest "Mind the Gap" report, the independent investment research firm found:

- In terms of the average dollar invested in mutual funds and ETFs, investors overall earned 9.31% per year over the past 10 years (through 2021).
- Still, that was 1.73 percentage points less than the total returns produced by their funds (11.04%) on a dollar-weighted basis during this timeframe.

Of course, such a performance gap as measured by Morningstar varied by fund category. As illustrated in the chart below, investors in sector rotation and nontraditional equity funds — i.e., those using hedging and related market timing techniques — fared the worst. Also worth noting: Allocation funds, which are typically set to follow a disciplined glide path or long-term asset allocation strategy, did appreciably better.

A natural question raised by such a report is: Who should be blamed for these shortfalls? Well, it turns out the answer is fairly clear-cut. Morningstar's researchers traced such diminished results to poor investment behavior. As their Mind the Gap report states:

"This shortfall, or gap, stems from poorly timed purchases and sales of fund shares, which cost investors nearly one sixth the return they would have earned if they had simply bought and held."

The most recent findings are in line with performance gaps measured over the four previous rolling 10-year periods, adds Morningstar. Those gaps ranged from 1.6 to 1.8 percentage points per year, the report notes.

The Morningstar study is another reminder that investors frequently let fear and other emotions guide the strategic investment process. It also brings to mind a term coined by behavioral finance researchers at Vanguard: Advisor Alpha. This refers to ongoing research by the funds provider seeking to quantify how much working with an objective investment professional can mean to an investment portfolio's *net total* return.

By focusing on strategies core to passive management and mitigating poor investment behavior, this long-running research series has found that a fiduciary-minded wealth advisor can help to increase an investor's portfolio returns by around 3% *net* in an average year. (You can read a complete review of Vanguard's study on Advisor Alpha here.)

This probably isn't a surprising development to our longtime clients. Mark Hebner founded IFA in 1999 with just such a concept in mind. In fact, IFA's menu of services offered to our clients takes a distinctly holistic approach to help each person meet his or her unique financial goals. That includes hundreds of articles, videos, books and research papers available through our website.

In recent years, we've also made the wealth of our educational materials and communications tools open for viewing on Apple iOS and Android devices through development of the Index Fund Advisors App. It's available to download from both the Apple App Store and the Google Play Store for Android.